Token Sales & The Risk Capital Test

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If you are considering token sales and selling blockchain tokens in the U.S., you not only have to worry about the U.S. federal securities laws (see the latest from the SEC ***here***), but also the laws of each state within the U.S. in which you sell the tokens.

Token Sales

Worrying about both federal and state law is something that happens whenever you offer to issue a security unless the federal law specifically preempts the state securities laws. Specific federal exemption occurs in very limited circumstances.

For example, if you are selling tokens to California and Washington residents, you have to worry about California and Washington state securities laws.

An example of federal preemption occurs under Rule 506(b). If you sell securities to only accredited investors under Rule 506(b), state law is preempted except for the requirement to file a Form D and pay the filing fees in states in which you have investors that require the filing.

In general though, the state securities laws exist side by side with the federal law and you have to comply with both. For example, if you issue stock options you have to comply with both federal and state law.

It is possible a token will **not** be a security under the federal securities law, but **will** be a security under a particular state's laws. This could make your coin offering, if you are considering one in which you sell coins to US residents, more difficult than you might expect.

What is the Risk Capital Test?

The risk capital test is a test some jurisdictions apply to determine whether in a particular transaction the instrument offered is a security. This test is different, and arguably more expansive, than the Howey test used by the SEC in its analysis finding that the DAO tokens qualified as securities. Further, each of the approximately 16 states that apply a risk capital analysis characterize it a bit differently, but there are common elements among them.

In Washington State, for example, the statutory definition of “security” includes this concept:

> “investment of money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture”

The Full Statutory Definition of Security in Washington State

Below is the full statutory definition of a security in Washington State, RCW 21.20.005(17)(a):

(17)(a) "Security" means any note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral-trust certificate; preorganization certificate or subscription; transferable share; investment contract; investment of money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture; voting-trust certificate; certificate of deposit for a security; fractional undivided interest in an oil, gas, or mineral lease or in payments out of production under a lease, right, or royalty; charitable gift annuity; any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities, including any interest therein or based on the value thereof; or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency; or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any security under this subsection. This subsection applies whether or not the security is evidenced by a written document.

Practical Application of the Risk Capital Test

If you are buying a blockchain token, you are investing money or other consideration into something. Are you investing it in the “risk capital” of a “venture with the expectation of some valuable benefit where you do not receive the right to exercise practical and actual control over the managerial decisions of the venture”?

It all depends on what the the terms of the token offering.

If the offering white paper tells you that you might expect some benefit from the increase in the value of the token being sold, does that mean the token is by definition a security under Washington law?

If you are buying a token for access to a computer network or software that doesn't yet exist, or exists but only in an early state, and your capital is “at risk” because it is going to be used to further develop the software, then there is a risk that you are selling a security under state law, even if the token is not a security under federal law.

One of the most famous cases in this area involved a country club to be built with membership funds.

[As an aside: we thing it is interesting and illuminating from a socialogical point of view that 30 years ago we were talking about whether memberships to clubs were securities and now we are taking about whether blockchain tokens are securities]

In the old, somewhat famous case re golf club memberships, the promoters hadn't built the club, but were selling memberships to build the club. The California Supreme Court held that this was a security under at risk test, even though the memberships only entitled the purchasers to use the club once it was built. They weren't entitled to a share of the profits of the club.

The case is worth reading when thinking about what is a security under states law for states who have adopted the risk capital test.

The analogy with a blockchain token sale is quite clear- even if the token is a software access token, a utility token, etc., if it is being offered far in advance of the service, and the funds raised from the sale of the token are usedto build the service (the “club”) then the purchaser's capital is in a sense being put at risk. And no matter how promising the project, arguably the person purchasing the token is in danger of never receiving the promised service. The valuable benefit, in such a case, would be the future service being provided, likely coupled with an increase in the value of the token as it changes from a future value to an immediate value. An access token being sold to raise money to build a software platform may be fine under the federal Howey test, but nevertheless certain states may consider it to be a security.

Contrast this with a token being offered where the service is immediately available. A software service might restrict usage using a permission/license token rather than a serial number, as is common with software products like Microsoft Office. Or perhaps a usage currency could provide a limited amount of access which is consumed when the user performs actions or acquires content.

Probably the easiest example of a type of token that could be sold that would not be a security would be a token that entitles you to play a video game that is already built. It is hard to see how that would be a security. It is no different than selling the rights to play a video game for cash. The service being provided is an entertainment software product, handed over immediately when the user purchases the token. This could take one of several different forms, such as the popular free-to-play model using a cryptocurrency instead of a platform-specific virtual currency (i.e. Riot Points, World of Tanks gold). It could be a token representing ownership of a digital game product, or DLC content within a game. Or, it could take the form of a token credit inserted to play a specific game once, in the fashion of an old-school arcade machine.

The important detail here is that in each of these cases the connection between the token and actually playing the game is immediate- the user is purchasing and receiving the product immediately, rather than an expectation of a future value as a consequence of a contribution of risk capital.

Still, what if a token features a mixture of characteristics? What if there are two or more types of tokens which are connected to one another or related to one another in some way- even if one of the tokens does not have an expectation of profit, perhaps a combination of tokens and/or smart contracts could create an expectation in the purchaser that a token will eventually return a profit. And how far in advance of the service being available is too far?

Again, the larger point to token issuers is—and this is somewhat of an understatement--issuing a token is not the easiest thing in the world to do, from a legal and regulatory compliance point of view. As a general takeaway, a simple tactic to avoid this "risk capital" issue is to just avoid issuing tokens to residents of those particular states applying the rule, but otherwise, structuring the tokens to reflect a (relatively) immediate consumable benefit, rather than a speculative future one, is a way to reduce the likelihood that tokens would be deemed securities under the risk capital test.
Disclaimer: This blog post is for information purposes only. It doesn't constitute legal advice or the establishment of an attorney-client relationship. Always consult with counsel before attempting to sell anything that might be a security.